



**U.S. Department of the Interior
Office of Inspector General**

AUDIT REPORT

**POHNPEI LOCAL OFFICE,
RURAL DEVELOPMENT PROGRAM,
U.S. DEPARTMENT OF AGRICULTURE,
FEDERATED STATES OF MICRONESIA**

**REPORT NO. 99-I-953
SEPTEMBER 1999**



United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

SEP 30 1999

Mr. Francis J. Blanco
State Director
Rural Development Program, Hawaii State Office
U.S. Department of Agriculture
Federal Building, Room 3 11
154 Waianuenue Avenue
Hilo, Hawaii 96720

Subject: Audit Report on the Pohnpei Local Office, Rural Development Program, U.S.
Department of Agriculture, Federated States of Micronesia (No. 99-I-953)

Dear Mr. Blanco:

This report presents the results of our audit of the Pohnpei Local Office's administration of loans provided under the Direct Single Family Housing Program. The objective of the audit was to determine whether the Pohnpei Local Office complied with U.S. Department of Agriculture loan and loan administration procedures. The scope of our review included Direct Single Family Housing Program loans that were outstanding during fiscal years 1997, 1998, and 1999 (through March 31, 1999). The audit was requested by the former Charge d' Affaires of the United States Embassy in the Republic of the Marshall Islands.

Our audit disclosed that the Pohnpei Local Office of the Rural Development Program was generally effective in making Direct Single Family Housing Program loans to borrowers who were eligible to participate in the loan program. However, we found that the Pohnpei Local Office made loans to 12 borrowers who constructed or repaired houses that were subsequently used for income-producing purposes and to 2 borrowers who constructed houses that, in our opinion, exceeded what would be considered "modest design" under program regulations.

These deficiencies occurred because (1) the Pohnpei Local Office and borrowers believed that the program regulations did not prohibit borrowers from leasing their houses, (2) the terms and conditions of the Real Estate Deed of Trust did not specifically require borrowers to reside in their houses, and (3) the Pohnpei Local Office did not adequately review loan documents and did not comply with program regulations when it approved a loan to a borrower who used the loan funds to construct commercial property. Regarding the design of the two houses, the Pohnpei Local Office (1) did not believe that one of the houses was unacceptably elaborate in design, (2) did not adequately monitor the construction of one house, and (3) approved a loan that exceeded the authorized maximum loan limit by \$15,000. As a result, Direct Single Family Housing Program loan funds of \$506,690 were not

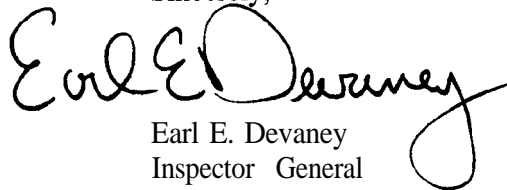
available for making loans to borrowers who were in need of safe and sanitary housing, three borrowers improperly received payment subsidies of \$8,032, and a loan of \$65,000 made to one borrower may be at risk. In addition, Direct Single Family Housing Program loan funds of \$135,000 were unavailable to other borrowers to construct houses that would have been in compliance with program requirements.

We made nine recommendations for corrective actions to you, as the State Director, Rural Development Program, Hawaii State Office. Based on your August 10, 1999, response (Appendix 2) to the draft report, we consider Recommendations A.3, A.6, B.1, and B.2 resolved and implemented and Recommendation A.4 unresolved and request additional information for Recommendations A. 1, A.2, AS, and B.3 (see Appendix 3).

Section 5(a) of the Inspector General Act (Public Law 95-452, as amended) requires the Office of Inspector General to list this report in its semiannual report to the Congress. Therefore, please provide a response, as required by Public Law 97-357, to this report by November 5, 1999. The response should be addressed to our Pacific Office, 415 Chalan San Antonio, Baltej Pavilion - Suite 306, Tamuning, Guam 969 11. The response should provide the information requested in Appendix 3.

We appreciate the assistance provided by the staff and management of the Pohnpei Local Office during the conduct of our audit.

Sincerely,

A handwritten signature in black ink, appearing to read "Earl E. Devaney". The signature is fluid and cursive, with a large loop at the end of the last name.

Earl E. Devaney
Inspector General

cc: Rural Development Manager, Western Pacific, Guam
Community Development Manager, Pohnpei Local Office

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INTRODUCTION

BACKGROUND

Title V of the Housing Act of 1949, as amended (42 U.S.C. 1471), authorized the Secretary of the U.S. Department of Agriculture to extend financial assistance, through the Farmers Home Administration,¹ to owners of farms and other real estate in rural areas for “the construction, improvement, alteration, or repair of dwellings, related facilities, and farm buildings and to rural residents, including persons who reside in reservations or villages of Indian tribes, for such purposes and for the purchase of buildings and the purchase of land constituting a minimum adequate site, in order to enable them to provide dwellings and related facilities for their own use.” Rural Development is the branch of the U.S. Department of Agriculture responsible for administering programs offered through the Rural Housing Service, the Rural Utilities Service, and the Rural Business-Cooperative Service.

The Compact of Free Association of 1985 between the Government of the United States and the Government of the Federated States of Micronesia (Public Law 99-239) was approved on January 14, 1986. As provided by Section 105(h)(1)(C) of the Compact, the United States and the Federated States agreed to continue the operation of Rural Development programs in each of the four states in the Federated States. Each of the Rural Development program local offices, which are located on the island states of Pohnpei, Chuuk, Kosrae, and Yap, has a Community Development Manager, who is supervised by the Rural Development Manager for the Western Pacific, who is located on Guam. The Rural Development Manager reports to the State Director, who is located in Hilo, Hawaii.

The Pohnpei Local Office is responsible for administering the Direct Single Family Housing Loan and Grant programs in the State of Pohnpei. The Code of Federal Regulations (7 CFR 3550.2) states:

The purpose of the direct [Rural Housing Service] single family housing loan programs is to provide low- and very low-income people who live in rural areas with an opportunity to own adequate but modest, decent, safe, and sanitary dwellings and related facilities. The Section 502 program offers persons who do not currently own adequate housing, and who cannot obtain other credit, the opportunity to acquire, build, rehabilitate, improve, or relocate dwellings in rural areas. The Section 504 program offers loans to very low-income homeowners who cannot obtain other credit to repair or rehabilitate their properties.

During fiscal year 1999, the Pohnpei Local Office had 2 locally hired Federal employees (a Community Development Manager and a Community Development Technician) and 18 employees paid by the Federated States of Micronesia National Government and the Pohnpei State Government. For fiscal year 1999, the National Government appropriated

¹The Federal Agriculture Improvement and Reform Act of 1996 changed the name of the Farmers Home Administration to Rural Development.

\$185,000 and the State Government appropriated \$147,246 for salaries and other expenses of the Pohnpei Local Office.

OBJECTIVE AND SCOPE

The objective of the audit was to determine whether the Pohnpei Local Office complied with U.S. Department of Agriculture loan and loan administration procedures. The scope of our review included Direct Single Family Housing loans that were outstanding during fiscal years 1997, 1998, and 1999 (through March 31, 1999). To obtain information on the processing and administration of loans, we interviewed officials at the United States Embassy, the Pohnpei Local Office, and the Office of the Public Auditor for the Federated States of Micronesia, all on Pohnpei; selected recipients of Direct Single Family Housing Program loans, also on Pohnpei; and officials of the Western Pacific Office on Guam. In addition, we reviewed loan documents maintained at the Pohnpei Local Office and computer listings of borrower accounts provided by the Rural Development Program's Centralized Servicing Center in St. Louis, Missouri, and made site visits to the homes of selected Direct Single Family Housing loan recipients on Pohnpei.

Our review was made, as applicable, in accordance with the "Government Auditing Standards," issued by the Comptroller General of the United States. Accordingly, we included such tests of records and other auditing procedures that were considered necessary under the circumstances.

As part of the audit, we evaluated the system of internal controls related to loan processing, construction monitoring, loan collections, and loan servicing. We did not identify any major control weaknesses in the area of loan collections. However, internal control weaknesses were identified in the areas of loan processing, construction monitoring, and loan servicing. These weaknesses are discussed in the Findings and Recommendations section of this report. Our recommendations, if implemented, should improve the internal controls in these areas.

PRIOR AUDIT COVERAGE

During the past 5 years, the U.S. General Accounting Office and the Office of Inspector General have not issued any audit reports pertaining to the Pohnpei Local Office, Rural Development Program, U.S. Department of Agriculture.

FINDINGS AND RECOMMENDATIONS

A. USE OF LOAN-FINANCED HOUSES

The Pohnpei Local Office made Rural Development Direct Single Family Housing Program loans to borrowers who either constructed or repaired houses that were subsequently used for income-producing purposes. Specifically, we found that 11 borrowers rented out their houses to generate income and one borrower used loan funds to construct a building that was partially used for commercial purposes. The Code of Federal Regulations (7 CFR 3550) states that loan funds are to be used by borrowers for a permanent residence and not for income-producing purposes. However, officials at the Pohnpei Local Office and borrowers said that they believed program regulations did not prohibit borrowers from leasing their houses. Also, the terms and conditions of the Real Estate Deed of Trust did not specifically require borrowers to reside in their houses. In addition, the Pohnpei Local Office did not adequately review loan documents and did not comply with program regulations when it approved a loan to a borrower who used loan funds to construct commercial property. As a result, Direct Single Family Housing Program loan funds of \$506,690 were not available to eligible borrowers, payment subsidies of \$8,032 were improperly received by three borrowers, and a loan of \$65,000 made to one borrower may be at risk (the monetary impacts of these amounts are presented in Appendix 1).

Residential Rental Properties

As of April 8, 1999, the Pohnpei Local Office had 109 Section 502 loans, with outstanding principal balances totaling \$5.3 million, and 1,691 Section 504 loans, with outstanding principal balances totaling \$6.3 million. Of these loans, we judgmentally selected for review a sample of 20 Section 502 loans, with outstanding principal balances totaling \$1.2 million, and 6 Section 504 loans, with outstanding principal balances totaling \$68,421.

We found that 11 of the 26 loan files reviewed (8 Section 502 loans, totaling \$461,690, and 3 Section 504 loans, totaling \$45,000) were used to construct or repair houses that were used as residential rental properties rather than as the borrowers' primary residences. According to the eight borrowers whom we interviewed, they elected to rent out their houses because they needed the income that would be generated by the leases. In addition, the borrowers told us that they did not know that the Direct Single Family Housing Program prohibited them from leasing their houses. As a result, the 11 borrowers used their houses, which were financed by loans totaling \$506,690, as residential rental properties, and 3 of the 11 borrowers improperly received payment subsidies of \$8,032 while collecting rental income on their houses. For example:

- An applicant requested and received a Section 502 loan of \$66,000 to construct a three-bedroom house, with monthly payments of \$440. The application showed that the house would be used as the applicant's primary residence. The loan closing was held on October 7, 1997, and the final inspection report stated that construction of the house was completed on April 14, 1998. The loan file contained an entry in the running case record

which showed that, on May 21, 1998, the Pohnpei Local Office became aware that the borrower was leasing his house. However, the loan file contained no documentation that the Pohnpei Local Office took any action to obtain a copy of the lease agreement or question the borrower about leasing his house. At our request, the Pohnpei Local Office's Community Development Manager contacted the borrower and obtained a copy of the lease agreement, which showed that on May 1, 1998, the borrower executed a 1 -year lease with a tenant at a monthly rental rate of \$2,500. Consequently, the borrower realized a profit of \$24,720 (\$2,500 less \$440 times 12 months) from the lease of his loan-financed house.

- Another applicant requested and received a Section 502 loan of \$49,990 to construct a three-bedroom house, with monthly loan payments of \$309. The loan closing was held on February 15, 1994, and based on the final inspection report, construction of the house was completed on June 28, 1994. Because of the borrower's low income, during the period of December 15, 1995, through July 15, 1998, the borrower received monthly payment subsidies from the Rural Development Program totaling \$4,856, which were used to reduce the amount of the borrower's monthly loan payments. Although the loan file did not contain any indication that the house was rented out, we determined that the borrower had executed two lease agreements with the same tenant to rent out the house during the period of December 10, 1995, through December 31, 1999, at a monthly rental rate of \$500. On March 12, 1999, we discussed this loan with the Pohnpei Local Office's Community Development Technician, who said that the borrower's payment subsidy was terminated in July 1998 because the Office learned that the borrower was leasing the house. On March 23, 1999, we interviewed the borrower to obtain copies of the lease agreements and to determine why the house was leased. The borrower told us that the house was rented because he was "desperately in need of money." Consequently, this borrower not only realized \$191 per month in rental income above his \$309 monthly loan payment but also improperly received payment subsidies totaling \$4,856.

The Pohnpei Local Office's Community Development Manager stated that he believed that the regulations did not prohibit borrowers from leasing their houses but agreed that the regulations prohibited borrowers from receiving payment subsidies while their houses were being rented out. However, the Code of Federal Regulations (7 CFR 3550.52(e)) states, "Loan funds may not be used to: ... Purchase or improve income-producing land or buildings to be used principally for income-producing purposes." The Code (7 CFR 3550.53) also states, "Applicants must agree to and have the ability to occupy the dwelling on a permanent basis." In addition, Section 12 of the Real Estate Deed of Trust² for the Federated States of Micronesia states that "neither the property nor any portion

²Because the Constitution of Pohnpei restricts the acquisition of permanent interest in real property to citizens of Pohnpei and prohibits the sale of land except as authorized through local statute, the Pohnpei Legislature enacted the Deed of Trust Act of 1987 to provide for the use of Real Estate Deeds of Trust instruments, by which the Pohnpei Housing Authority would act as trustee for financing agencies of the U.S. Government with the authority to foreclose on property financed by United States agencies. Additionally, through a 1991 memorandum of understanding between the Pohnpei Housing Authority and the Farmers Home Administration (now Rural Development), the Pohnpei Housing Authority agreed to maintain an escrow account of \$500,000 to serve as a reserve account to satisfy the trustee's obligations to the Farmers Home Administration in the event of default on a loan by a borrower.

thereof or interest therein shall be leased, assigned, sold, transferred, or encumbered, voluntarily or otherwise, without the written consent of the Government [of the United States].” None of the 11 borrowers who subsequently rented out their loan-financed houses had obtained written approval from the Rural Development Program.

We discussed, with an attorney from the Office of General Counsel, U.S. Department of Agriculture, in San Francisco, California, the issue of borrowers renting out houses that had been financed through Direct Single Family Housing Program loans. The attorney stated that Rural Development may wish to consider sending notices to the 11 borrowers to advise them that they had violated the terms and conditions of their Real Estate Deeds of Trust and instruct them to terminate the lease agreements with their tenants and move into their houses. The attorney also suggested that Rural Development, to prevent the program from being used improperly in the future, may wish to consider (1) modifying the terms and conditions of the Real Estate Deed of Trust for the Federated States of Micronesia to require that the house be owner occupied and (2) developing a separate document to be used at loan closing that would require borrowers to certify that they will reside in their houses unless they obtain express written consent from Rural Development to lease their houses because of hardship or other special circumstances. Consequently, we believe that the Rural Development Program State Office in Hawaii should review the 11 loans and seek assistance, as necessary, from the Office of General Counsel, U.S. Department of Agriculture, to correct this deficiency and to prevent the Direct Single Family Housing Program in Pohnpei from being used improperly in the future.

Commercial Property

We also found that a loan of \$65,000 was approved for a borrower who used part of the loan funds to complete the construction of commercial property. Specifically, on March 6, 1997, the Pohnpei Local Office received an application for a Section 502 loan of \$65,000 from the Executive Director of the Pohnpei State Housing Authority (the Trustee for Direct Single Family Housing Program loans on Pohnpei). The floor plans submitted by the Executive Director showed that he planned to construct a two-story building. However, on May 6, 1997, the engineer at the Pohnpei Local Office who reviewed the floor plans made an entry in the loan file’s running case record which stated that the floor plans gave the appearance that the Executive Director intended to use the first floor of the building for commercial purposes and the second floor for residential purposes. The engineer subsequently visited the construction site and, on May 13, 1997, made another entry in the running case record which stated that the Executive Director “is intending for a commercial loan, not a regular rural housing loan: Therefore, I’m referring [the] case file to supervisory personnel.” On the same date, the engineer made another entry in the running case record which stated that after inspecting the existing one-story structure, he concluded that the structure was “unfinished and incomplete.” The loan file also showed that the Executive Director subsequently submitted revised floor plans which, based on our inspection, appeared similar to the first set of plans submitted to the Pohnpei Local Office except that handwritten captions had been entered on the plans for the first floor rooms, labeling the rooms as “kitchen,” “dining,” “living,” and “bedroom.”

On March 22, 1999, the Pohnpei Local Office's former Community Development Specialist who was involved in the processing of this loan told us that the first floor of the building was constructed prior to the approval of the loan. However, the Community Development Specialist told us that the construction "was incomplete on the first floor and it needed additional work" because the first floor had no electrical wiring, plumbing, doors, or windows. The Community Development Specialist also said that the existing structure had cracks in the walls and ceiling which had to be repaired and that support columns needed to be added on the first floor to ensure that the structure could support the weight of the second floor. In addition, based on the cost summary prepared for the construction of the building, we determined that loan funds of at least \$25,714 were to be used to complete the construction of the first floor. Nevertheless, the Pohnpei Local Office accepted the floor plans and approved a loan of \$65,000.

On October 6, 1998, the Housing Authority's Executive Director wrote a letter to the Community Development Manager that stated, "Although it [the building] is substantially completed, there are some things yet to be done to fully complete the building. For that reason, I have submitted an application for supplemental funding." Based on the scope of work provided by the Housing Authority's Executive Director, some of the additional work on the building was to include the installation of steel grilles over the windows on the first floor; the construction of a bar counter on the second floor; and the building of structures on the roof of the building, including a bathroom and a *nahs*.³ However, on March 1, 1999, the Pohnpei Local Office disapproved the Executive Director's loan request, stating that (1) the loan funds were to be used for "unauthorized purposes," (2) the *nahs* would not meet typhoon-resistance standards, and (3) the structure was not being used primarily for residential purposes.

Based on our review of the original floor plans, we agree that the first floor of the building appeared to be designed for commercial purposes. However, to determine whether the first floor of the building was used for commercial purposes, we visited the property on March 24, 1999, and found that while the second floor of the building was used for residential purposes, the first floor was being used for commercial office space and a bingo parlor. We also noted that a *nahs*, restroom facilities, kitchen sink, barbeque grill, and a decorative water fountain had been constructed on the roof of the building.

During our review of the loan file, we also found that the two-story building was constructed on land that had been leased from the Pohnpei State Public Lands Authority. The Lease of Public Lands for Commercial Purposes, which covered the period of January 16, 1973, through January 17, 2023, provided the Housing Authority Executive Director with the use of 1,178 square meters of land at an annual rental rate of \$353. Article 1, Item 2, of the lease agreement specified that the purpose of the lease was to allow the tenant to provide "office space, restaurant & bar." In addition, Article 2 of the lease stated, "The premises are leased and shall be used, except with the express written consent of the Authority, only for the commercial purposes specified in item 2." However, we found no documentation in the loan

³A "*nahs*" is a thatched-roof structure used for recreational purposes.

file that the Executive Director had obtained consent from the Lands Authority to also use the land for residential purposes, for which the second floor of the building was used.

In our opinion, the Pohnpei Local Office should not have approved this loan to the Housing Authority Executive Director because (1) the existing first floor was to be used for commercial purposes and needed additional work before the second floor could be constructed and (2) the lease agreement for the land on which the building was constructed did not authorize the use of the land for residential purposes. In addition, we believe that because of the Executive Director's position with the Pohnpei State Housing Authority, he should have been aware of the restrictions on the use of funds provided under the Direct Single Family Housing Program. Further, the entire \$65,000 loan could be at risk if the Lands Authority chooses to cancel the lease and takes possession of the property. Accordingly, we believe that the Hawaii State Office should review the case file for this loan to determine what actions should be taken to protect Rural Development's and the Trustee's interests in the property.

Recommendations

We recommend that the State Director, Rural Development Program, Hawaii State Office:

1. Conduct a review, with the assistance of the Office of General Counsel, U.S. Department of Agriculture, of the loan files for the 11 borrowers who used Direct Single Family Housing Program loan funds to construct or repair houses that were used as residential rental properties rather than as the borrowers' primary residences and, if warranted, take appropriate actions based on the results of the review.

2. Conduct a review of the loan file for the borrower who used Direct Single Family Housing Program loan funds to construct a structure that was partially used for commercial purposes to determine what actions should be taken to protect Rural Development's and the Trustee's interests in the property.

3. Instruct the Community Development Manager, Pohnpei Local Office, to review all Section 502 and a sample of Section 504 loan files and make site visits to the houses to determine whether borrowers are using their houses in accordance with program regulations.

4. Develop written procedures to require that the Pohnpei Local Office emphasizes to borrowers during the initial loan interview that the purpose of the Direct Single Family Housing Program is to provide borrowers with a permanent residence and perform periodic site visits to borrowers' houses to determine whether the houses are used in accordance with Program regulations. The written procedures should also provide the Pohnpei Local Office with the steps needed for it to follow to prohibit borrowers from using their houses for commercial purposes.

5. Request assistance from the Office of General Counsel, U.S. Department of Agriculture, to modify the terms and conditions of the Real Estate Deed of Trust for the Federated States of Micronesia to include a requirement that loan-financed houses should be

owner occupied and develop a separate document to be used at loan closing that will require borrowers to certify that they will reside in their houses unless they obtain express written approval from Rural Development to lease their houses because of hardship or other special circumstances.

6. Instruct the Community Development Manager, Pohnpei Local Office, to initiate collection actions against the three borrowers who improperly received payment subsidies of \$8,032.

Hawaii State Office Response and Office of Inspector General Reply

In the August 10, 1999, response (Appendix 2) to the draft report from the Director, Hawaii State Office, the State Office stated general concurrence with all six of the recommendations. Based on the response, we consider Recommendations 3 and 6 resolved and implemented and Recommendation 4 unresolved and request additional information for Recommendations 1, 2, and 5 (see Appendix 3).

In addition, the State Office requested that the Office of Inspector General provide a list of the names of the 12 borrowers who used Direct Single Family Housing Program loan funds to construct or repair houses that were used for commercial purposes. These names were provided to the State Office in a letter dated September 3, 1999.

Recommendation 4. Concurrence indicated.

Hawaii State Office Response. The State Office included in its response a copy of an August 10, 1999, memorandum from the State Director to the Pohnpei Local Office's Community Development Manager that instructed the Community Development Manager to ensure that an Applicant Orientation Guide (Form RD 3550-23) is signed by each applicant, the loan originator, and the Community Development Manager and filed in the loan docket. The State Office stated that a similar form (Exhibit D of FmHA Instruction 1944-A) was used prior to the implementation of Form RD 3550-23, and the State Office further stated that it believes that "it is not the inadequacy of the existing documents, but the failure of the Pohnpei Local Office to properly administer the programs and the lack of close supervision of that office" that caused the deficiencies cited in our audit.

Office of Inspector General Reply. During our audit, we noted that the Pohnpei Local Office was using Exhibit D of FmHA Instruction 1944-A, which states that borrowers must personally occupy their residences if they wish to receive a payment subsidy. In addition, Form RD 3550-23 requires borrowers to obtain approval from Rural Development before they lease their houses. Also, the Real Estate Deed of Trust for the Federated States of Micronesia includes restrictions similar to those shown on Form RD 3 5 50-23. However, as stated in the finding, the borrowers we interviewed stated that (1) they were unaware that leasing their houses violated program requirements and (2) they leased their houses because they needed the income. Therefore, the use of these forms did not ensure that borrowers complied with program requirements. Additionally, the State Director said that the Pohnpei Local Office did not adequately administer and supervise the program. Therefore, our

recommendation was focused on enhancing the existing procedures by requiring the Community Development Manager, Pohnpei Local Office, to (1) emphasize to borrowers the requirement that they should live in any property financed by a Rural Development loan, (2) conduct periodic site visits to ensure that borrowers complied with this requirement, and (3) take action against borrowers who used their loan financed property for commercial or other nonresidential purposes. Because the State Office did not specifically address these aspects of the recommendation, we consider it unresolved.

B. DESIGN OF LOAN-FINANCED HOUSES

The Pohnpei Local Office made Rural Development Direct Single Family Housing Program loans to borrowers who constructed houses that exceeded what would be considered a modest house design on the island of Pohnpei and made a loan to one borrower that exceeded the maximum authorized loan amount by \$15,000. The Code of Federal Regulations defines a "modest dwelling" for Rural Development program loan purposes. However, deficiencies occurred because (1) the Community Development Manager, Pohnpei Local Office, said that he did not believe one of the two houses was elaborate in design, (2) the Pohnpei Local Office did not adequately monitor at least one construction project to ensure that the house was constructed in accordance with the approved house plans, and (3) the Pohnpei Local Office did not comply with the Section 502 loan limit established by the Hawaii State Office when it approved a loan to one borrower. As a result, Direct Single Family Housing Program loan funds of \$135,000 were not available for other borrowers to construct houses under Program requirements (see Appendix 1).

House Designs

Based on our review of 20 Section 502 loans, with outstanding principal balances totaling \$1.2 million, we found that three loans, totaling \$135,000, were made to two borrowers who used the funds to construct houses that were not, in our opinion, "modest" in design when compared with the typical residence observed on the island of Pohnpei. The Code of Federal Regulations (7 CFR 3550.57(a)), in defining a "modest dwelling," states, "The property must be one that is considered modest for the area, must not be designed for income providing purposes, must not have an in-ground pool or have a cost in excess of the section 203(b) limit of the National Housing Act unless [the Rural Housing Service] authorizes an exception."

On December 5, 1994, the Pohnpei Local Office received an application for a Section 502 loan of \$40,000. In a September 2, 1996, written report on his review of the application and other supporting documents in the loan file, the Community Development Specialist stated, "The applicant with a family of 04 people are presently living in a concrete dwelling which is not safe, decent, & sanitary." The Community Development Specialist's written report also stated, "The proposal is to repair [a] concrete residential dwelling of 2,275 square feet with 3 bedrooms and 2 bathrooms." The loan closing was held on January 2, 1997, and based on the final inspection report on the house, construction was completed on April 7, 1997. However, our review of the floor plans in the loan file disclosed that the two-story house was to have a total of five bedrooms and a kitchen, a dining room, a living room, and a family room on the first floor and a kitchen, a dining room, and a family room on the second floor. Because the floor plans gave the appearance that the house design exceeded what may be considered a modest house design for Pohnpei, we made a site visit to the house. Based on the site visit, we concluded that the house was not of modest design as compared with other residences on the island of Pohnpei.

On April 9, 1996, the Pohnpei Local Office received an application for a Section 502 loan of \$75,000. In an April 10, 1996, written report on their review of the application and other

supporting documents in the loan file, Pohnpei Local Office officials stated that the applicant planned to construct a three-bedroom, three-bathroom house of 2,892 square feet. The written report also stated, "The design is within the restriction set forth [for] a family of 6 and it appears that it will meet the needs of this applicant." The loan closing was held on July 10, 1997, and a contract was executed on the same date for construction of a one-story house at a cost of \$75,000.

According to the construction contract, the construction of the house was to commence by August 26, 1997, and to be completed by January 26, 1998. However, construction was delayed because the construction site was located at the top of a steep hill and some of the heavy equipment needed during construction could not reach the site. Consequently, on August 8, 1997, the borrower submitted to the Pohnpei Local Office another loan application for an additional loan of \$20,000 to construct a 2 1/2-foot by 16-foot driveway. The loan was subsequently approved by the Pohnpei Local Office, and on May 20, 1998, the borrower executed a contract to construct the driveway. Thus, the borrower received a total of \$95,000 to construct the house and the driveway.

Our review of the floor plans in the loan file disclosed that the design of the house appeared to exceed what would be considered a modest house on the island of Pohnpei. In addition, we noted a May 23, 1998, entry in the running case record which stated that the Pohnpei Local Office's engineer visited the construction site and found that the design of the house had been changed to include the construction of a second floor. However, no action was taken by the Pohnpei Local Office to stop the construction of the second floor. We also noted, based on documents in the loan file, that the borrower had requested an additional loan of \$38,000 to complete the construction of the house. However, in an October 29, 1998, letter to the borrower, the Pohnpei Local Office stated that "we are unable to approve your application on the basis that your total indebtedness with the agency will exceed the present authorized loan amount." As a result of our review of the loan file, on March 16, 1999, we visited the construction site and found that a two-story house which appeared to be more than modest was under construction. In our opinion, the Pohnpei Local Office should monitor the construction of houses financed by Rural Development Program loans and require that borrowers obtain the approval of the Office before making changes to the approved construction plans.

In addition to the design of this house, the total \$95,000 amount of the two loans made to this borrower exceeded the \$80,000 maximum loan amount that had been established by the Hawaii State Office at the time the borrower applied for the second \$20,000 loan in August 1997. The Community Development Manager said that this borrower was allowed to receive loans in excess of the established limit because he had been told by a State Office official during a July 1996 training session on Guam that the maximum loan amount was going to be increased by the Hawaii State Office. The Community Development Manager also stated that he had not received any notice of an increase but had processed the \$20,000 loan because he believed that, if the maximum authorized loan amount had not been increased, the loan would have been rejected by the Rural Development Program's automated loan processing system. However, the Rural Development Manager on Guam told us that the automated loan processing system did not have an edit check to detect loans in excess of the maximum

amount authorized and that the Community Development Manager was responsible for ensuring that loans were within the allowable limit.

Recommendations

We recommend that the State Director, Rural Development Program, Hawaii State Office:

1. Instruct the Community Development Manager, Pohnpei Local Office, to ensure that houses of future loan applicants are of modest design as compared with the typical residences on Pohnpei.

2. Instruct the Community Development Manager, Pohnpei Local Office, to ensure that construction projects are closely monitored and that any changes made by borrowers to the approved house plans are reviewed and approved in advance by the Pohnpei Local Office.

3. Seek legal assistance from the Office of General Counsel, U.S. Department of Agriculture, to determine the proper actions to take to recover the \$15,000 from the borrower who received loan funds in excess of the allowable maximum.

Hawaii State Office Response and Office of Inspector General Reply

In the August 10, 1999, response (Appendix 2) to the draft report from the Director, Hawaii State Office, the State Office stated general concurrence with all three recommendations. Based on the response, we consider Recommendations 1 and 2 resolved and implemented and request additional information for Recommendation 3 (see Appendix 3).

4

CLASSIFICATION OF MONETARY AMOUNTS

<u>Finding Areas</u>	<u>Funds To Be Put To Better Use*</u>
A. Use of Loan-Financed Houses	
Residential Rental Properties	\$5 14,722
Commercial Property	65,000
B. Design of Loan-Financed Houses	<u>135,000</u>
Totals	<u>\$714,722</u>

*Amounts represent Federal funds.



FRANCIS J. BLANCO
State Director

Ted K. Matsuo
Program Director, RUS

Thao Khamoui
Program Director, RHS

Steven R. Chapman
Program Director, RBS

United States Department of Agriculture
Rural Development

Hawaii State Office - Western Pacific Region
Room 311 Federal Building
154 Waiānūenue Avenue
Hilo, Hawaii 96720

APPENDIX 2
Page 1 of 5
Rural Utilities Service (RUS)
Rural Housing Service (RHS)
Rural Business-Cooperative Service (RBS)

Telephone: (808) 933-8380
FAX: (808) 933-8327

August 10, 1999

Mr. Robert J. Williams, Acting Inspector General
United States Department of Interior
Pacific Office
415 Chalan San Antonio, Baltej Pavillion - Suite 306
Tamuning, Guam 969 11

Dear Mr. Williams:

We appreciate the opportunity to respond to a Draft Audit Report on the Pohnpei Local Office (Assignment No. N-IN-FSM-001-99-R). We concur with the general findings and recommendations and would like to share the findings of our independent investigations and immediate administrative actions taken. Enclosed are the following internal memos.

- December 30, 1998, memo received from Pohnpei Community Development Manager (CDM)
- January 8, 1999, memo to Rural Development Manager (RDM) on maximum loan and loan approval authority.
- February 11, 1999, memo from Pohnpei CDM to RDM.
- February 19, 1999, memo on revocation of loan approval authority.
- February 26, 1999, memo from RDM was received, cc: Pohnpei CDM.
- March 10, 1999, memo on revocation of loan and grant approval authority.
- March 12, 1999, memo from RDM was received.
- April 15, 1999, memo to Sam W. Currie, Regional OIG.
- April 28, 1999, memo to Regional OIG.

The following are our responses to the recommendation in the draft audit.

Recommendation #1: Conduct a review, with the assistance of the Office of General Counsel, U.S. Department of Agriculture, of the loan files for the 11 borrowers who used Direct Single Family Housing Program loan funds to construct or repair houses that were used as residential rental properties rather than as the borrowers' primary residences and take appropriate action based on the results of the review.

Mr. Robert J. Williams, Acting Inspector General
United States Department of Interior
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Response: Please identify the 11 borrowers for our record and see paragraph 1 of the enclosed August 10, 1999, memo to the Community Development Manager in Pohnpei.

Recommendation #2: Conduct a review of the loan file for the borrower who used Direct Single Family Housing Program loan funds to construct a structure that was partially used for commercial purposes to determine what actions should be taken to protect Rural Development's and the Trustee's interest in the property.

Response: Please identify the borrower for our record and see paragraph 1 of the enclosed August 10, 1999, memo to the Community Development Manager in Pohnpei.

Recommendation #3: Instruct the Community Development Manager, Pohnpei Local Office, to review all Section 502 and a sample of Section 504 loan files and make site visits to the houses to determine whether borrowers are using their houses in accordance with program regulations.

Response: See paragraph 2 of the enclosed August 10, 1999, memo to the Community Development Manager in Pohnpei.

Recommendation #4: Develop written procedures to require that the Pohnpei Local Office emphasizes to borrowers during the initial loan interview that the purpose of the Direct Single Family Housing Program is to provide borrowers with a permanent residence and performs periodic site visits to borrowers' houses to determine whether the houses are used in accordance with program regulations. The written procedures should also provide the Pohnpei Local Office with the necessary steps to follow to prohibit borrowers from using their houses for commercial purposes.

Response: See paragraph 3 of the enclosed August 10, 1999, memo to the Community Development Manager in Pohnpei.

Recommendation #5: Request assistance from the Office of General Counsel, U.S. Department of Agriculture, to modify the terms and conditions of the Real Estate Deed of Trust for the Federated States of Micronesia to include a requirement that loan-financed houses should be owner occupied and develop a separate document to be used at loan closing that will require borrowers to certify that they will reside in their houses unless they obtain express written approval from Rural Development to lease their houses because of hardship or other special circumstances.

Response: We will consult our Office of General Counsel as recommended. However, we believe it is not the inadequacy of the existing documents, but the failure of the Pohnpei Local Office to properly administer the programs and the lack of close supervision of that office. We also believe

Mr. Robert J. Williams, Acting Inspector General
United States Department of Interior
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the enclosed Form RD 3550-23, Applicant Orientation Guide, already meets recommendation (2) on page 9 of the draft audit. It includes the following:

- No loan can be closed until Agency staff have reviewed this information with the applicants, and all applicants have completed Part II. Certifications.
- Borrowers must personally occupy the property, and must inform the Agency whenever an adult member of the household changes or obtains employment, when there is change in family status, or when nonemployment income increases by more than 10 percent.
- A borrower must obtain approval from the Agency before taking actions that may affect the security value of the property. Key actions that require approval from the Agency include: subordination of the loan, mineral leases, partial release of security, lease of security property, and assumption of indebtedness.
- Unauthorized assistance includes any loan, payment subsidy, deferred mortgage payment, or grant for which there was no regulatory authorization or for which the recipient was not eligible. Account adjustments may be made to correct for the receipt of unauthorized assistance and any subsidy granted improperly will be repaid by the borrower. Borrowers who receive unauthorized assistance based on false information provided intentionally to obtain benefits are at risk of losing their loan, debarment from participation in federal benefit programs, and civil and criminal prosecution.

Older loans should have on file a similar document, Exhibit D of FmHA Instruction 1944-A, enclosed.

The draft audit correctly cited on page 8 sections 7 CFR 3550.52(e) on income producing properties and 7 CFR 3550.52 on occupancy.

Recommendation #6: Instruct the Community Development Manager, Pohnpei Local Office, to initiate collection actions the three borrowers who improperly received payment subsidies of \$8,032.

Response: See paragraph 4 of the enclosed August 10, 1999, memo to the Community Development Manager in Pohnpei.

Recommendation #7: Instruct the Community Development Manager, Pohnpei Local Office, to ensure that houses of future loan applicants are of modest design as compared with the typical residences of Pohnpei.

Response: See paragraph 5 of the enclosed August 10, 1999, memo to the Community Development Manager in Pohnpei.

Mr. Robert J. Williams, Acting Inspector General
United States Department of Interior
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Recommendation #8: Instruct the Community Development Manager, Pohnpei Local Office, to ensure that construction projects are closely monitored and that any changes made by borrowers to the approved house plans are reviewed and approved in advance by the Pohnpei Local Office.

Response: Also see paragraph 5 of the enclosed August 10, 1999, memo to the Community Development Manager in Pohnpei.

Recommendation #9: Seek legal assistance from the Office of General Counsel, U.S. Department of Agriculture, to determine the proper actions to take to recover the \$15,000 from the borrower who received loan funds in excess of the allowable maximum.

Response: We will consult our Office of General Counsel as recommended.

Sincerely,



FRANCIS J. BLANCO
State Director

Enclosures

cc: Nigel Parish, Rural Development Manager, Mongmong (w/o enclosures)
Steve Peyton, Administrative Director (w/o enclosures)
Thao Khamoui, SFWCF Program Director (w/o enclosures)

[NOTE - THE AUGUST 10, 1999, MEMORANDUM FROM THE STATE DIRECTOR, RURAL DEVELOPMENT, U.S. DEPARTMENT OF AGRICULTURE, IS THE ONLY ENCLOSURE INCLUDED BY THE OFFICE OF INSPECTOR GENERAL.]



United States Department of Agriculture
Rural Development

Rural APPENDIX 2
Rural Page 5 of 5

Rural Business - Co

Hawaii State Office - Western Pacific Region
Room 311 Federal Building
1.54 Waiianuenue Avenue
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Telephone: (808) 933-8380
FAX: (808) 933-8327

FRANCIS J. BLANCO
State Director

August 10, 1999

SUBJECT: Draft Audit Report

TO: Community Development Manager
Pohnpei, FSM

Ted K. Matsuo
Program Director, RUS

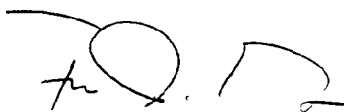
The following are recommended by the Draft Audit Report (Assignment No. N-IN-FSM-001-99-R):

Thao Khamoui
Program Director, RHS

1. Please immediately submit to the Rural Development Manager (RDM) the 11 borrowers who used loan funds to construct or repair houses that were used as residential rental properties, and one borrower who used some loan funds for commercial purposes as identified in this subject audit for his review and recommendations to me for appropriate actions in accordance with Chapter 7 of HB-2-3550.
2. As recommended in the draft audit, you are to review ALL Section 502 and ALL SECURED Section 504 loan files and make site visits to the houses to determine whether borrowers are using their houses in accordance with program regulations. A priority must be given to this review and submit your report to the RDM by no later than September 9, 1999, for his further review and recommendations to me by no later than October 9, 1999. The RDM may also make site visits as necessary.
3. During the July 1996 training session in Guam, you were informed of the required form RD 3550-23, Applicant Orientation Guide, which must be signed by applicants and loan originator. You must personally sign Form RD 3550-23 and make sure that it is tiled in each Section 502 loan docket.
4. You need to immediately initiate, with assistance **from** the RDM as necessary, collection actions against the three borrowers who improperly received payment subsidies of \$8,032 as reported in the draft audit.
5. You must ensure that houses of future loan applicants are of modest design as compared with the typical residences of Pohnpei. You must also ensure that construction projects are closely monitored and that any changes made by borrowers to the approved house plans are reviewed and approved in advance by the Pohnpei Local Office.
6. Further, please be advised that my memo to you dated March 10, 1999, regarding "Revocation of Loan and Grant Approval" still remains in full force and effect until further notice.

Steven R. Chapman
Program Director, RBS

If you have any questions, please contact the Area/State Office as appropriate.


FRANCIS J. BLANCO
State Director

cc: RDM, Mongmong, GU

STATUS OF AUDIT REPORT RECOMMENDATIONS

Finding/Recommendation Reference	Status	Action Required
A.1	Management concurs; additional information needed.	Provide a target date for completing the review of the 11 borrowers who used Direct Single Family Housing Program loan funds to construct or repair houses that were used as residential rental properties. When completed, a copy of the review results and the actions taken should be provided to our office.
A.2	Management concurs; additional information needed.	Provide a target date for completing the review of the borrower who used Direct Single Family Housing Program loan funds to construct a structure that was partially used for commercial purposes. When completed, a copy of the results of the review and the actions taken to protect Rural Development's and the Trustee's interests in the property should be provided to our office.
A.3	Implemented.	No further action is required.
A.4	Unresolved.	Reconsider the response to the recommendation. If concurrence is indicated, provide an action plan that includes the target date and the title of the official responsible for implementation. If nonconcurrence is indicated, provide reasons for the nonconcurrence.

2

<u>Finding/Recommendation Reference</u>	<u>Status</u>	<u>Action Required</u>
A.5	Management concurs; additional information needed.	Provide a target date and the title of the official responsible for requesting assistance from the Office of General Counsel to modify the terms and conditions of the Real Estate Deed of Trust for the Federated States of Micronesia and for developing a separate document to be used at loan closing that will require borrowers to certify that they will reside in their houses unless they obtain written approval from Rural Development to lease their houses because of hardship or other special circumstances. When completed, a copy of the modified Real Estate Deed of Trust and the separate document should be provided to our office.
A.6	Implemented.	No further action is required.
B.1 and B.2	Implemented.	No further action is required.
B.3	Management concurs; additional information needed.	Provide a target date and the title of the official responsible for requesting assistance from the Office of General Counsel to determine the proper actions to take to recover the \$15,000 from the borrower who received loan funds in excess of the allowable maximum amount. When completed, a copy of the recommendations made by the Office of General Counsel should be provided to our office.

**ILLEGAL OR WASTEFUL ACTIVITIES
SHOULD BE REPORTED TO
THE OFFICE OF INSPECTOR GENERAL**

Internet/E-Mail Address

www.oig.doi.gov

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